

106TH CONGRESS
1ST SESSION

S. 1415

To amend the Internal Revenue Code of 1986 to provide for S corporation reform, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 22, 1999

Mr. HATCH introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1986 to provide for S corporation reform, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE;**

4 **TABLE OF CONTENTS.**

5 (a) SHORT TITLE.—This Act may be cited as the
6 “Subchapter S Revision Act of 1999”.

7 (b) AMENDMENT OF 1986 CODE.—Except as other-
8 wise expressly provided, whenever in this Act an amend-
9 ment or repeal is expressed in terms of an amendment
10 to, or repeal of, a section or other provision, the reference

1 shall be considered to be made to a section or other provi-
 2 sion of the Internal Revenue Code of 1986.

3 (c) TABLE OF CONTENTS.—The table of contents is
 4 as follows:

Sec. 1. Short title; amendment of 1986 code; table of contents.

TITLE I—ELIGIBLE SHAREHOLDERS OF AN S CORPORATION

Sec. 101. Members of family treated as 1 shareholder.

Sec. 102. Nonresident aliens allowed to be shareholders.

TITLE II—QUALIFICATION AND ELIGIBILITY REQUIREMENTS OF S CORPORATIONS

Sec. 201. Issuance of preferred stock permitted.

Sec. 202. Safe harbor expanded to include convertible debt.

Sec. 203. Repeal of excessive passive investment income as a termination event.

Sec. 204. Repeal of passive income capital gain category.

Sec. 205. Allowance of charitable contributions of inventory and scientific prop-
 erty.

Sec. 206. C corporation rules to apply for fringe benefit purposes.

TITLE III—TAXATION OF S CORPORATION SHAREHOLDERS

Sec. 301. Treatment of losses to shareholders.

TITLE IV—EFFECTIVE DATE

Sec. 401. Effective date.

5 **TITLE I—ELIGIBLE SHARE-** 6 **HOLDERS OF AN S CORPORA-** 7 **TION**

8 **SEC. 101. MEMBERS OF FAMILY TREATED AS 1 SHARE-** 9 **HOLDER.**

10 Paragraph (1) of section 1361(c) (relating to special
 11 rules for applying subsection (b)) is amended to read as
 12 follows:

13 “(1) MEMBERS OF FAMILY TREATED AS 1
 14 SHAREHOLDER.—

1 “(A) IN GENERAL.—For purpose of sub-
2 section (b)(1)(A)—

3 “(i) except as provided in clause (ii),
4 a husband and wife (and their estates)
5 shall be treated as 1 shareholder, and

6 “(ii) in the case of a family with re-
7 spect to which an election is in effect
8 under subparagraph (E), all members of
9 the family shall be treated as 1 share-
10 holder.

11 “(B) MEMBERS OF THE FAMILY.—For
12 purpose of subparagraph (A)(ii), the term
13 ‘members of the family’ means the lineal de-
14 scendants of the common ancestor and the
15 spouses (or former spouses) of such lineal de-
16 scendants or common ancestor.

17 “(C) COMMON ANCESTOR.—For purposes
18 of this paragraph, an individual shall not be
19 considered a common ancestor if, as of the later
20 of the effective date of this paragraph or the
21 time the election under section 1362(a) is
22 made, the individual is more than 6 generations
23 removed from the youngest generation of share-
24 holders.

1 “(D) EFFECT OF ADOPTION, ETC.—In de-
 2 termining whether any relationship specified in
 3 subparagraph (B) or (C) exists, the rules of
 4 section 152(b)(2) shall apply.

5 “(E) ELECTION.—An election under sub-
 6 paragraph (A)(ii)—

7 “(i) must be made with the consent of
 8 all shareholders,

9 “(ii) shall remain in effect until termi-
 10 nated, and

11 “(iii) shall apply only with respect to
 12 1 family in any corporation.”.

13 **SEC. 102. NONRESIDENT ALIENS ALLOWED TO BE SHARE-**
 14 **HOLDERS.**

15 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-
 16 HOLDERS.—

17 (1) IN GENERAL.—Paragraph (1) of section
 18 1361(b) (defining small business corporation) is
 19 amended—

20 (A) by adding “and” at the end of sub-
 21 paragraph (B),

22 (B) by striking subparagraph (C), and

23 (C) by redesignating subparagraph (D) as
 24 subparagraph (C).

1 (2) CONFORMING AMENDMENTS.—Paragraph
 2 (4) and (5)(A) of section 1361(c) (relating to special
 3 rules for applying subsection (b)) are each amended
 4 by striking “subsection (b)(1)(D)” and inserting
 5 “subsection (b)(1)(C)”.

6 (b) NONRESIDENT ALIEN SHAREHOLDER TREATED
 7 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED
 8 STATES.—

9 (1) IN GENERAL.—Section 875 is amended—

10 (A) by striking “and” at the end of para-
 11 graph (1),

12 (B) by striking the period at the end of
 13 paragraph (2) and inserting “, and”, and

14 (C) by adding at the end the following new
 15 paragraph:

16 “(3) a nonresident alien individual shall be con-
 17 sidered as being engaged in a trade or business
 18 within the United States if the S corporation of
 19 which such individual is a shareholder is so en-
 20 gaged.”

21 (2) APPLICATION OF WITHHOLDING TAX ON
 22 NONRESIDENT ALIEN SHAREHOLDERS.—Section
 23 1446 (relating to withholding tax on foreign part-
 24 ners’ share of effectively connected income) is
 25 amended by redesignating subsection (f) as sub-

1 section (g) and by inserting after subsection (e) the
 2 following new subsection:

3 “(f) S CORPORATION TREATED AS PARTNERSHIP,
 4 ETC.—For purposes of this section—

5 “(1) an S corporation shall be treated as a
 6 partnership,

7 “(2) the shareholders of such corporation shall
 8 be treated as partners of such partnership; and

9 “(3) any reference to section 704 shall be treat-
 10 ed as a reference to section 1366.”

11 (3) CONFORMING AMENDMENTS.—

12 (A) The heading of section 875 is amended
 13 to read as follows:

14 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES**
 15 **AND TRUSTS; S CORPORATIONS.”**

16 (B) The heading of section 1446 is amend-
 17 ed to read as follows:

18 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’**
 19 **AND S CORPORATION SHAREHOLDERS’**
 20 **SHARE OF EFFECTIVELY CONNECTED IN-**
 21 **COME.”**

22 (4) CLERICAL AMENDMENTS.—

23 (A) The item relating to section 875 in the
 24 table of sections for subpart A of part II of

1 subchapter N of chapter 1 is amended to read
 2 as follows:

“Sec. 875. Partnerships; beneficiaries of estates and trusts; S corporations.”

3 (B) The item relating to section 1446 in
 4 the table of sections for subchapter A of chap-
 5 ter 3 is amended to read as follows:

“Sec. 1446 Withholding tax on foreign partners’ and S corporation share-
 holders’ share of effectively connected income.”

6 (C) PERMANENT ESTABLISHMENT OF
 7 PARTNERS AND S CORPORATION SHARE-
 8 HOLDERS.—Section 894 (relating to income af-
 9 fected by treaty) is amended by redesignating
 10 subsection (c) as subsection (d) and inserting
 11 the following new subsection after subsection
 12 (b):

13 “(c) PERMANENT ESTABLISHMENT OF PARTNERS
 14 AND S CORPORATION SHAREHOLDERS.—If a partnership
 15 or S corporation has a permanent establishment in the
 16 United States (within the meaning of a treaty to which
 17 the United States is a party) at any time during a taxable
 18 year of such entity, a nonresident alien individual or for-
 19 eign corporation which is a partner in such partnership,
 20 or a nonresident alien individual who is a shareholder in
 21 such S corporation, shall be treated as having a permanent
 22 establishment in the United States for purposes of such
 23 treaty.”

1 **TITLE II—QUALIFICATION AND**
 2 **ELIGIBILITY REQUIREMENTS**
 3 **OF S CORPORATIONS**

4 **SEC. 201. ISSUANCE OF PREFERRED STOCK PERMITTED.**

5 (a) IN GENERAL.—Section 1361 is amended by add-
 6 ing at the end the following new subsection:

7 “(f) TREATMENT OF QUALIFIED PREFERRED
 8 STOCK.—

9 “(1) IN GENERAL.—For purposes of this
 10 subchapter—

11 “(A) qualified preferred stock shall not be
 12 treated as a second class of stock, and

13 “(B) no person shall be treated as a share-
 14 holder of the corporation by reason of holding
 15 qualified preferred stock.

16 “(2) QUALIFIED PREFERRED STOCK DE-
 17 FINED.—For purposes of this subsection, the term
 18 ‘qualified preferred stock’ means stock which meets
 19 the requirements of subparagraphs (A), (B), and (C)
 20 of section 1504(a)(4). Stock shall not fail to be
 21 treated as qualified preferred stock merely because
 22 it is convertible into other stock.

23 “(3) DISTRIBUTIONS.—A distribution (not in
 24 part or full payment in exchange for stock) made by
 25 the corporation with respect to qualified preferred

1 stock shall be includible as ordinary income of the
 2 holder and deductible to the corporation as an ex-
 3 pense in computing taxable income under section
 4 1363(b) in the year such distribution is received.”

5 (b) CONFORMING AMENDMENTS.—

6 (1) Paragraph (1) of section 1361(b) is amend-
 7 ed by inserting “, except as provided in subsection
 8 (f),” before “which does not”.

9 (2) Subsection (a) of section 1366 is amended
 10 by adding at the end the following new paragraph:

11 “(3) ALLOCATION WITH RESPECT TO QUALI-
 12 FIED PREFERRED STOCK.—The holders of qualified
 13 preferred stock (as defined in section 1361(f)) shall
 14 not, with respect to such stock, be allocated any of
 15 the items described in paragraph (1).”

16 (3) So much of clause (ii) of section
 17 354(a)(2)(C) as precedes subclause (II) is amended
 18 to read as follows:

19 “(ii) RECAPITALIZATION OF FAMILY-
 20 OWNED CORPORATIONS AND S CORPORA-
 21 TIONS.—

22 “(I) IN GENERAL.—Clause (i)
 23 shall not apply in the case of a recap-
 24 italization under section 368(a)(I)(E)

1 of a family-owned corporation or S
2 corporation.”

3 (4) Subsection (a) of section 1373 is amended
4 by striking “and” at the end of paragraph (1), by
5 striking the period at the end of paragraph (2) and
6 inserting “, and”, and by adding at the end the fol-
7 lowing new paragraph:

8 “(3) no amount of an expense deductible under
9 this subchapter by reason of section 1361(f)(3) shall
10 be apportioned or allocated to such income.”

11 **SEC. 202. SAFE HARBOR EXPANDED TO INCLUDE CONVERT-**
12 **IBLE DEBT.**

13 Subparagraph (B) of section 1361(c)(5) (defining
14 straight debt) is amended by striking clauses (ii) and (iii)
15 and inserting the following:

16 “(ii) in any case in which the terms of
17 such promise include a provision under
18 which the obligation to pay may be con-
19 verted (directly or indirectly) into stock of
20 the corporation, such terms, taken as a
21 whole, are substantially the same as the
22 terms which could have been obtained on
23 the effective date of the promise from a
24 person which is not a related person (with-

1 in the meaning of section 465(b)(3)(C)) to
 2 the S corporation or its shareholders, and
 3 “(iii) the creditor is—
 4 “(I) an individual,
 5 “(II) an estate,
 6 “(III) a trust described in para-
 7 graph (2), or
 8 “(IV) a person which is actively
 9 and regularly engaged in the business
 10 of lending money.”

11 **SEC. 203. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**
 12 **COME AS A TERMINATION EVENT.**

13 (a) IN GENERAL.—Section 1362(d) (relating to ter-
 14 mination) is amended by striking paragraph (3).

15 (b) CONFORMING AMENDMENTS.—

16 (1) Section 1362(f)(1) is amended by striking
 17 “or (3)”.

18 (2) Clause (i) of section 1042(c)(4)(A) is
 19 amended by striking “section 1362(d)(3)(C)” and
 20 inserting “section 1375(b)(4)”.

21 **SEC. 204. REPEAL OF PASSIVE INCOME CAPITAL GAIN CAT-**
 22 **EGORY.**

23 Subsection (b) of section 1375 is amended by striking
 24 paragraphs (3) and (4) and inserting the following new
 25 paragraphs:

1 “(3) SUBCHAPTER C EARNINGS AND PROF-
 2 ITS.—The term ‘subchapter C earnings and profits’
 3 means earnings and profits of any corporation for
 4 any taxable year with respect to which an election
 5 under section 1362(a) (or under section 1372 of
 6 prior law) was not in effect.

7 “(4) PASSIVE INVESTMENT INCOME DE-
 8 FINED.—

9 “(A) IN GENERAL.—Except as otherwise
 10 provided in this paragraph, the term ‘passive
 11 investment income’ means gross receipts de-
 12 rived from royalties, rents, dividends, interest,
 13 and annuities.

14 “(B) EXCEPTION FOR INTEREST ON
 15 NOTES FROM SALES OF INVENTORY.—The term
 16 ‘passive investment income’ shall not include in-
 17 terest on any obligation acquired in the ordi-
 18 nary course of the corporation’s trade or busi-
 19 ness from its sale of property described in sec-
 20 tion 1221(1).

21 “(C) TREATMENT OF CERTAIN LENDING
 22 OR FINANCE COMPANIES.—If the S corporation
 23 meets the requirements of section 542(c)(6) for
 24 the taxable year, the term ‘passive investment
 25 income’ shall not include gross receipts for the

1 taxable year which are derived directly from the
2 active and regular conduct of a lending or fi-
3 nance business (as defined in section
4 542(d)(1)).

5 “(D) TREATMENT OF CERTAIN DIVI-
6 DENDS.—If an S corporation holds stock in a
7 C corporation meeting the requirements of sec-
8 tion 1504(a)(2), the term ‘passive investment
9 income’ shall not include dividends from such C
10 corporation to the extent such dividends are at-
11 tributable to the earnings and profits of such C
12 corporation derived from the active conduct of
13 a trade or business.

14 “(E) COORDINATION WITH SECTION
15 1374.—The amount of passive investment in-
16 come shall be determined by not taking into ac-
17 count any recognized built-in gain or loss of the
18 S corporation for any taxable year in the rec-
19 ognition period. Terms used in the preceding
20 sentence shall have the same respective mean-
21 ing as when used in section 1374.”

1 **SEC. 205. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**
 2 **OF INVENTORY AND SCIENTIFIC PROPERTY.**

3 (a) IN GENERAL.—Section 170(e) (relating to certain
 4 contributions of ordinary income and capital gain prop-
 5 erty) is amended—

6 (1) by striking “(other than a corporation
 7 which is an S corporation)” in paragraph (3)(A),
 8 and

9 (2) by striking clause (i) of paragraph (4)(D)
 10 and by redesignating clauses (ii) and (iii) of such
 11 paragraph as clauses (i) and (ii), respectively.

12 (b) STOCK BASIS ADJUSTMENT.—Paragraph (1) of
 13 section 1367(a) (relating to adjustments to basis of stock
 14 of shareholders, etc.) is amended by striking “and” at the
 15 end of subparagraph (B), by striking the period at the
 16 end of subparagraph (C) and inserting “, and”, and by
 17 adding at the end the following new subparagraph:

18 “(D) the excess of the deductions for char-
 19 itable contributions over the basis of the prop-
 20 erty contributed.”

21 **SEC. 206. C CORPORATION RULES TO APPLY FOR FRINGE**
 22 **BENEFIT PURPOSES.**

23 (a) IN GENERAL.—Section 1372 (relating to partner-
 24 ship rules to apply for fringe benefit purposes) is repealed.

25 (b) PARTNERSHIP RULES TO APPLY FOR HEALTH
 26 INSURANCE COSTS OF CERTAIN S CORPORATION SHARE-

1 HOLDERS.—Paragraph (5) of section 162(l) is amended
 2 to read as follows:

3 “(5) TREATMENT OF CERTAIN S CORPORATION
 4 SHAREHOLDERS.—

5 “(A) IN GENERAL.—This subsection shall
 6 apply in the case of any 2-percent shareholder
 7 of an S corporation, except that—

8 “(i) for purposes of this subsection,
 9 such shareholder’s wages (as defined in
 10 section 3121) from the S corporation shall
 11 be treated as such shareholder’s earned in-
 12 come (within the meaning of section
 13 401(c)(1)), and

14 “(ii) there shall be such adjustments
 15 in the application of this subsection as the
 16 Secretary may by regulations prescribe.

17 “(B) 2-PERCENT SHAREHOLDER DE-
 18 FINED.—For purposes of this paragraph, the
 19 term ‘2-percent shareholder’ means any person
 20 who owns (or is considered as owning within
 21 the meaning of section 318) on any day during
 22 the taxable year of the S corporation more than
 23 2 percent of the outstanding stock of such cor-
 24 poration or stock possessing more than 2 per-

1 cent of the total combined voting power of all
 2 stock of such corporation.”

3 (b) CONFORMING AMENDMENT.—The table of sec-
 4 tions for part III of subchapter S of chapter 1 is amended
 5 by striking the item relating to section 1372.

6 **TITLE III—TAXATION OF S** 7 **CORPORATION SHAREHOLDERS**

8 **SEC. 301. TREATMENT OF LOSSES TO SHAREHOLDERS.**

9 (a) LIQUIDATIONS.—Section 331 (relating to gain or
 10 loss to shareholders in corporate liquidations) is amended
 11 by redesignating subsection (c) as subsection (d) and by
 12 inserting after subsection (b) the following new subsection:

13 “(c) LOSS ON LIQUIDATIONS OF S CORPORATION.—

14 “(1) IN GENERAL.—The portion of any loss rec-
 15 ognized by a shareholder of an S corporation (as de-
 16 fined in section 1361(a)(1)) on amounts received by
 17 such shareholder in a distribution in complete liq-
 18 uidation of such S corporation which does not exceed
 19 the ordinary income basis of stock of such S cor-
 20 poration in the hands of such shareholder shall not
 21 be treated as a loss from the sale or exchange of a
 22 capital asset but shall be treated as an ordinary loss.

23 “(2) ORDINARY INCOME BASIS.—For purposes
 24 of this subsection, the ordinary income basis of stock
 25 of an S corporation in the hands of a shareholder of

1 such S corporation shall be an amount equal to the
 2 portion of such shareholder's basis in such stock
 3 which is equal to the aggregate increases in such
 4 basis under section 1367(a)(1) resulting from such
 5 shareholder's pro rata share of ordinary income of
 6 such S corporation attributable to the complete liq-
 7 uidation."

8 (b) SUSPENDED PASSIVE ACTIVITY LOSSES.—Para-
 9 graph (3) of section 1371(b) is amended to read as fol-
 10 lows:

11 “(3) TREATMENT OF S YEAR AS ELAPSED
 12 YEAR; PASSIVE LOSSES.—Nothing in paragraphs (1)
 13 and (2) shall prevent treating a taxable year for
 14 which a corporation is an S corporation as a taxable
 15 year for purposes of determining the number of tax-
 16 able years to which an item may be carried back or
 17 carried forward nor prevent the allowance of a pas-
 18 sive activity loss deduction to the extent provided by
 19 section 469(g).”

20 **TITLE IV—EFFECTIVE DATE**

21 **SEC. 401. EFFECTIVE DATE.**

22 (a) IN GENERAL.—Except as otherwise provided in
 23 this Act, and in section 1362(g) relating to elections after
 24 termination, the amendments made by this Act shall apply
 25 to taxable years beginning after December 31, 1999.

1 (b) TREATMENT OF CERTAIN ELECTIONS UNDER
2 PRIOR LAW.—For purposes of section 1362(g) of the In-
3 ternal Revenue Code of 1986 (relating to election after
4 termination), any termination or revocation under section
5 1362(d) of such Code (as in effect on the day before enact-
6 ment of this Act) shall not be taken into account.

○